SUMMARY ANALYSIS OF AMENDED BILL

Franchise Tax Board

Author: Calderon | Analyst: Colin Stevens | Bill Number: AB 687

Related Bills: See Prior Analysis | Telephone: 845-3036 | Amended Date: 5/13/99

Attorney: Patrick Kusiak | Sponsor: CIPA

SUBJECT: Percentage Depletion Deduction/Oil And Gas Wells

____ DEPARTMENT AMENDMENTS ACCEPTED. Amendments reflect suggestions of previous analysis of bill as introduced/amended _________.

X AMENDMENTS IMPACT REVENUE. A new revenue estimate is provided.

X AMENDMENTS DID NOT RESOLVE THE DEPARTMENT'S CONCERNS stated in the previous analysis of bill as amended APRIL 26, 1999.

X FURTHER AMENDMENTS NECESSARY.

____ DEPARTMENT POSITION CHANGED TO ________________________.

X REMAINDER OF PREVIOUS ANALYSIS OF BILL AS AMENDED APRIL 26, 1999, STILL APPLIES.

____ OTHER - See comments below.

SUMMARY OF BILL

Under the Personal Income Tax Law (PITL) and the Bank and Corporation Tax Law (B&CTL), this bill would make the following changes for independent oil producers, as defined:

1. Increase to 20,000 from 1,000 the number of barrels of oil that may be produced daily while still permitting a taxpayer to take percentage depletion;
2. Increase the maximum allowable percentage that may be used in calculating the deduction for percentage depletion. The amount of the increase would depend upon the price of certain specified crude oil;
3. Specify that the additional percentage that may be used in calculating the deduction for percentage depletion would be allowed only to independent producers and not royalty owners;
4. Remove a depletion limitation cap of 100% of the taxpayer's taxable income from the property;
5. Remove the depletion limitation cap of 65% of the taxpayer's modified taxable income;
6. Increase from $5 million to $15 million the amount of gross receipts above which a taxpayer cannot qualify to receive percentage depletion because the taxpayer is then considered a retailer of oil or natural gas;
7. Allow a 15-year carryforward of any depletion deduction that cannot be used in the year generated;
8. Allow certain property currently ineligible for percentage depletion for periods after 1974 to be eligible for percentage depletion.

Board Position:			Department/Legislative Director	Date
____ S	____ NA	____ NP		
____ SA	____ O	____ NAR		
X N	____ OUA	____ PENDING	**Johnnie Lou Rosas**	**5/26/1999**

SUMMARY OF AMENDMENT

The May 13, 1999, amendment removes the three-year carryback provision applicable to the depletion deduction and provides a repeal date for each of the bill's provisions of December 31, 2006. Except for the resolution of certain policy considerations related to the three-year carryback provision, the addition of a technical and the first two implementation considerations, and a new revenue estimate, the analysis of the bill as amended April 26, 1999, still applies. The implementation and technical considerations are provided below.

Implementation Considerations

It is unclear how the author intends the provisions repealing the limitation on percentage depletion for certain properties transferred after 1974 to be applied if the sections of law repealing those limitations are themselves repealed. If the author intends for the repeal of the limitation to be permanent, additional clarification should be provided to ensure that the author's intent is properly carried out.

Most tax provisions specify a beginning operative date and ending operative date, (i.e. for tax years beginning on or after January 1, 1999, and before January 1, 2006) and a repeal date so taxpayers and the department have certainty as to when the provisions of law apply. This bill does not specify a beginning or an ending operative date, which could cause difficulties for taxpayers determining when the bill's provisions apply to them. This bill provides a repeal date of December 31, 2006, which differs from December 1, the date usually provided for a provision's repeal. To ensure that the operative dates apply as intended by the author, and that calendar year filers have the same opportunity to claim tax benefits as fiscal year filers, the author may wish to consider specifying beginning and ending operative date language, and a repeal date of December 1 of the year of repeal.

Standard carryover language for credits specifies that a credit amount that exceeds the amount of net tax would be carried forward to future years. This bill specifies that a deduction attributable to this bill could be carried forward for 15 years, but does not describe whether the period would begin in the year in which the deduction is claimed. In addition, it is not clear what amount is actually subject to the carry forward treatment. The author's staff has indicated that the intent is to permit carry forward of only the amount of the percentage depletion deduction computed under the rules in this bill that is in excess of any deduction allowed for cost depletion. Additional language would be required to accomplish the author's intent.

This bill specifies that the $12 price of Kern River 13 degree crude be adjusted each year for inflation. However, many price indexes are available, and to avoid disputes, the index should be specifically defined in the bill. It would assist the department if the $12 price were indexed to the California Consumer Price Index in a manner similar to other items in the Revenue and Taxation Code. In addition, it would be helpful if the baseline date from which inflation adjustments are to be computed was clearly specified in the bill.

The author's office has indicated that this bill is intended to apply only to those portions of a taxpayer's operations located inside California. This bill will require additional language to carry out the author's expressed intent.

It is unclear where department staff would get the information to verify the average Kern River posting price for the California refineries. According to staff from the Department of Conservation Division of Oil and Gas, the posting price for each refinery is available, but no single source posts the aggregate of the daily prices posted for the four refineries. Compiling the information in order to verify the average posting price for all four refineries, potentially on a daily basis, could require significant expenditure of department staff resources.

A specified formula to compute the average daily posting price and the aggregating of the daily prices to determine the average posting price for a calendar year would assist the department in implementation of this bill and help ensure disputes do not arise between taxpayers and the department.

The author's office has indicated that deductions for percentage depletion under this bill are intended to be allowed to reduce regular tax below the tentative minimum tax. Percentage depletion deductions are not currently part of the alternative minimum taxable income calculations. However, certain aspects of an oil or gas producer's operations, such as intangible drilling costs, often do produce AMT interactions. Additional language to alter the general AMT provisions would be required to allow the additional deductions for percentage depletion generated under this bill to reduce the total amount of tax paid by independent oil producers.

Federal law defines a "domestic producer." However, this bill does not define a "domestic producer." Since a domestic producer could be either a producer in California or one in the United States, additional clarification as to the author's intent could help to ensure that disputes do not arise between taxpayers and department staff.

The provision relating to the depletion limitation cap of 50% specifies that it would apply for taxable years beginning after December 31, 1995, creating the potential for amended returns and an additional minor workload.

Technical Considerations

The author's office has indicated that subdivision (b) of Sections 17683 and 24833 is intended to allow a taxpayer whose average daily production exceeds the increased daily per barrel amount allowed by this bill to allocate that production to fields that would benefit most from the additional percentage depletion. The bill's language would need additional clarification to accomplish this intent.

This bill would provide in two places that certain property ineligible for using percentage depletion for periods after 1974 could utilize percentage depletion in the calculation of deductions. It is unclear why the provision needs to be identified twice in the bill. Further, the language in this bill that would allow percentage depletion for properties ineligible after 1974 specifies that it would apply to a "transfer," while the repealed federal language specifies that it applies to a "transferee."

The B&CTL provisions use the term "taxable year" in several places. The B&CTL provisions should refer instead to "income year."

The language for additional deductions may be confusing since it could be read that the qualified taxpayers would receive a deduction of 10% if the price of oil is between $11.99 and $10 per barrel, 20% if the price is between $9.99 and $8.00, etc, instead of an increased amount over the basic 15% specified in Section 613A(c)(1) of the Internal Revenue Code. However, the author's office has indicated its intent that the percentages specified in the bill would be 25%, 35% and 45%. The bill would be clearer if language substituting total percentage amounts (including the basic 15% amount plus the enhanced amount, if any) were inserted rather than the existing language.

This bill refers to the "posting price" of crude oil. The terminology usually used by the industry is "posted price."

FISCAL IMPACT

Tax Revenue Estimate

The estimated revenue impact of this bill is shown in the following table:

Revenue Impact of AB 687 As Amended May 13, 1999 Effective for Tax Years Beginning on and After January 1, 1999 Assumed enactment after June 30, 1999 $ Millions		
1999-00	2000-01	2001-02
-$2	-$3	-$3

This analysis does not take into account any change in employment, personal income, or gross state product that may result from this bill becoming law.

Tax Revenue Discussion

The revenue impact of the original bill (-$4 million, -$5 million and -$5 million) is reduced to reflect the elimination of the carry-back provision. The remaining assumptions and analyses are the same as the original bill.

BOARD POSITION

Neutral.